EXHIBIT 34

PART

Two

The Sell Side: Distribution and Market-Making Roles

The Handbook of Municipal Bonds
By Sylvan G. Feldstein and Frank J. Fabozzi

CHAPTER 14

The Role of the Underwriter

Christopher J. Mier, CFA
Managing Director
Loop Capital Markets

This chapter discusses the complex role of the underwriter in a new issue municipal financing. The underwriter artfully stands in between the issuer and investor and seeks to price new issues such that an efficient and fair market is created for both buyer and seller. The discussion in this chapter touches on the many functions an underwriter must perform in meeting the challenges of bringing new issues to market in ever-changing market environments.

THE UNDERWRITER'S ROLE IN CONTEXT

A municipal bond originates as an idea. Initially, a unit of government—a city, a county, or a school district, for example—has a project that needs financing. It could be a new courthouse, jail, or water treatment facility. Or perhaps it is a new generating plant for an electric utility, or an expansion of a hospital. The list of possible uses of tax-exempt financing available through the municipal market is enormous. In any case, what starts out as a project in the gleam of a finance director's eye gets transformed into a municipal bond issue through a process that starts within the unit of government and winds its way through various professional organizations it has hired to assist in the creation and distribution of a municipal bond issue. The end result of this process is a bond issue that has been sold to the investing public—both retail and institutional. In return, the governmental issuer receives the financing that it needs to construct the project.

The various parties that are involved with a newly germinated municipal bond issue include the issuer's finance director (and staff) and in-house legal counsel. The issuer will frequently select a financial consultant, a bond

counsel, and a senior managing underwriting firm (and other comanaging underwriters, as well) to underwrite the new issue. The senior managing underwriter may have their own counsel to represent them. The firm that is the senior managing underwriter will have numerous investment bankers working with the issuer to help construct the financing plan for the project. In addition, that firm will have someone called an *underwrite*r whose principal responsibility is to commit the firm's capital towards the pricing and distribution of the new securities in the primary marketplace. While the involvement of all of the various participants is essential in the financing process, the role that the underwriter plays is a particularly pivotal one. The underwriter will, in essence, take the issue from the investment banking staff and shepherd it the rest of the way until it reaches the hands of the investor—the ultimate destination for the bonds along the new issue pathway.

The process of initiating a municipal bond issue and guiding it to its ultimate destination—the hands of the investor—is a lengthy process that never follows the exact same course twice. When the marketplace functions effectively, the issuer is able to sell bonds to finance its projects at a cost that is satisfactory, and the investor is able to buy bonds at a price that he also deems acceptable. The underwriter, in effect, stands at the crossroads of the supply and demand for capital and ensures that a market clearing transaction takes place for each bond issue that his firm underwrites. During this process he has to satisfy the diverse constituencies of issuer and investor, all while putting the firm's capital at risk.

WHEN DOES THE UNDERWRITER BECOME INVOLVED IN THE PROCESS?

As previously mentioned the underwriter bridges the gap between issuer and investor and is principally responsible for the successfully pricing and selling of a new issue municipal bond. An underwriter is at the center of the creation and distribution process of a new municipal bond issue. The underwriter contributes to the investment banking process—the creation stage—by providing valuable market feedback on current conditions in the bond market and how they might impact the transaction. As the day of the issue will be priced approaches, the underwriter helps the sales manager kick start the selling process by providing a detailed explanation of the salient aspects of the financing to the sales manager, who coordinates the sales effort. On pricing day the underwriter proposes a pricing to the issuer which, if accepted, will be used by the underwriting team to start the sales and distribution process.

In a typical financing, an underwriter first enters the process shortly after the senior managing underwriting firm has been chosen, along with an underwriting group, to underwrite the issue. The underwriter of the lead firm will participate in conference calls between the issuer, its financial consultant, and the firm's investment bankers, bond counsel, and others. At this stage of the process, the underwriter will mostly be providing useful commentary about market conditions currently prevailing, and any preliminary feedback that might be appropriate relative to the structure of the bond issue that the issuer and its financing team (the issuer, and their financial consultant and investment bankers) have considered. For example, if the financing contemplates the use of zero-coupon bonds as part of a refunding strategy, the underwriter may have a valuable contribution to make in terms of the current receptivity in the marketplace for zero-coupon bonds, and the price they are likely to command as part of the new issue. If there has been a lack of zero-coupon bonds in the market, and the few that are available are commanding huge prices, the underwriter will highlight this to the financing team. If the market is reeling from stronger than expected economic reports that are giving off worrisome inflation signals, and interest rates have been rising, the underwriter will be sure to mention this as well. If the pricing date that is tentatively scheduled turns out to be a heavy one for the municipal market, the underwriter will point this out. In the early goings, the underwriter is the financing team's eyes and ears of the market. He (or she) points out all salient market conditions that may influence the reception that a bond issue might expect to receive in the prevailing market environment, whether they are positive or negative.

As the pricing date of the issue approaches, the frequency with which the underwriter will communicate with the issuing client and the rest of the financing team will increase dramatically. Simultaneously, the underwriter will continue to gather additional market information to prepare for the pricing and sale of the issue. This reconnaissance is a vital function of the underwriter and is critical to providing the information that will enable the success of the issue upon pricing. The underwriter will be monitoring other issues in the market place that have similar characteristics to the issue that he will be pricing. He will use all of his available sources of information—street contacts, other underwriters, his own sales force, and the like—to better understand the level of demand and the prices being paid for various types of bond characteristics in the marketplace. These characteristics include the general category of the bond, general obligation or revenue bond, the term or maturity structure of the financing, the coupon structure, the state of origin, the call feature, the rating and many others. The underwriter will monitor all relevant new issue financings in both the competitive and negotiated markets. Additionally, he will watch the secondary market for indications

of how various types of bonds are trading. If his firm is going to bring to market a local California school district general obligation bond with a 30-year serial structure and MBIA insurance, for example, the underwriter will carefully monitor market conditions with respect to all of these features, and any others he thinks may yield valuable information that will help him price and sell the transaction for the issuer.

The underwriter has a significant arsenal at his disposal with which he can gather information, but the underwriter must select his sources of information carefully. For example, let's say the issuer has indicated an interest in nine-year par calls instead of the standard 10-year call feature. In surveying the landscape, the underwriter notes that there hasn't been an issue in the market with a nine-year call in over a month. The underwriter must discreetly ascertain what reception the contemplated structure would likely receive without divulging information to the marketplace prematurely. The underwriter must have a sixth sense as to where and how to gather as much accurate information as possible so that on "game day"—the day the issue is initially priced—he can price an issue that satisfies the pricing requirements of both issuer and investor.

THE LEAD-UP TO PRICING

The day before pricing there will typically be a conference call between the issuer, its financial advisor, and the senior manager of the underwriting team. The underwriter for the senior managing firm will play a key role in this call. He will lead the group in discussing and analyzing market conditions that relate specifically to the bond issue that is to be priced. The financing team will finalize the proposed structure of the issue, and the underwriter will supply a likely scale for the transaction. The group will determine a game plan for the day of pricing. They will select a time for an early conference call to make any last minute revisions to the pricing scale and for the underwriter to receive formal approval from the issuer to release the scale. They will plan for a call when the group will reconvene to discuss the orders that have been received and any plans for repricing, if necessary.

During the course of the sales process hundreds of clients will be contacted by the firm's sales force to determine their interest in the issue. The sales force will relay critical feedback from investing clients back to the underwriting desk. The feedback will include the specific orders that some clients will have at the existing pricing, as well as what changes a client might require before being willing to present an order. An example might be an indication of interest subject to a change in structure or price ("I would take $5 million in 2025, if you can do a 5.00% coupon instead of a 4.75%

coupon."). The order period is like a huge electronic bazaar with sales people interacting vigorously with their clients and relating vital information back to the underwriting desk.

If the issue has required repricing—raising or lowering prices—the underwriter has to wait to see if the orders will stay or if investors will choose to drop. A reprice is, in effect, a free option for the investors. Now that the price of the issue has been changed, the investor can watch the market and wait for more market information to decide if he is going to stay or drop. The sales person covering the account provides a vital function during this time by supplying the underwriter with valuable feedback as to the customer's state of mind and probability of staying or dropping. The underwriter is putting both the firm's capital at risk as well as the quality of the firm's relationship with the issuer. A deal that does not go well can result in significant underwriting losses. Gauging investor sentiment is critical to the process of underwriting new issue securities.

To be a good underwriter an individual needs to have strong negotiation and presentation skills. Being able to justify a price change to an issuer of municipal bonds who is convinced that their bonds are worth gold is not an easy task under time-constrained circumstances! The timing and presentation of the deal to the investor community is important as well. Such things as whether to go out with pricing before a competing issue or after, whether to offer a short or a long order period, creating a pricing structure that maximizes the interest of the investing community while minimizing the cost the issuer has to pay are all key factors in a successful underwriting.

What kinds of things can go wrong with a new issue underwriting? Rapidly changing market conditions can make new issue underwriting difficult and may result in the underwriter incorrectly gauging investor interest relative to a given proposed pricing structure. As an additional example the issuer may decide that they are being short-changed on the proposed pricing of their bond issue. "Let's go out with a 4.23% yield on the 30-year-term bonds instead of a 4.25%." The underwriter, bound by the necessity to get the best possible price for the client's issue, may feel compelled to swallow hard and release a pricing that he may feel is too high in price (and too low in yield) for the market to embrace. While, on the surface, this may not seem like a problem since any bonds that fail to generate sufficient interest from buyers during an order period can be repriced, unsold bonds in a new issue syndicate can taint the issue and create negative momentum in the execution of the transaction that may ultimately cost the issuer more than if they had gone out with the original recommended price. Ultimately, it is unpredictable movements in the market that wreak havoc on new issues. When the bond market falls 30 minutes after the initial price release of a new issue and

investors turn cautious, the underwriter must rely on experience and sound judgment to guide the issue towards a satisfactory completion.

What's the mark of good transaction? A good transaction is one that satisfies all parties that a fair transaction has been effected in a fair process that has provided adequate transparency to all parties involved. While there are no set standards, an example of a "classic" underwriting might be one where the bonds are priced into a receptive market, receiving a subscription of about 1.5 to 2 times across all maturities, enabling the bonds to get "bumped" in price slightly, while losing only a nominal amount of business. A "Goldilocks" level of subscription (not too hot, not too cold) of around 1.5 to 2 times provides assurance to the issuer that their bonds have been priced correctly, and simultaneously reassures buyers that they have bought a reasonably "tight" deal where they will get allocated adequate amounts of bonds that are well placed. An issuer will generally regard a small reprice as a signal that the bonds were not priced too cheap for starters (a large price increase can be upsetting to issuers) while buyers want access to reasonable allocations on deals that they feel have been fairly priced by the underwriter.

A difficult task that the underwriter must perform after the pricing phase has been concluded is the allocation of bonds. When the final pricing has been transmitted, and all investors have had the opportunity to stay or drop, the underwriter will take the order pad (a computer printout) and head for an undisclosed location to decide how to allocate the bonds. The underwriter must decide how the bonds are to be allocated among the investors. If the 2020 maturity has $5 million in par value, but has received orders of $5 million, $3.5 million, and $1.5 million, a two times oversubscription, then a decision has to be made as to how to distribute the bonds between the investors submitting orders. In allocating bonds, the underwriter must be bound by his duty to the issuer, and a responsibility to be fair to his investor clients. Within those broad parameters there is room for the underwriter to use his own judgment. From a buyer's perspective, ideally, the bonds will be allocated to investors who sincerely want them for long-term investment purposes and who will not sell them in the secondary market at the first possible opportunity for short-term profit, thereby reducing the perceived value of the bonds of the customers who continue to hold the issue.

In conclusion, the underwriter fulfills a key function in the process of creating and bringing a bond issue to market. The underwriter must stand squarely in the middle of supply and demand and settle on a market clearing price that can make two diverse and inherently conflictual parties satisfied. Then, after the price is finalized, he must allocate the bonds to investors in a manner that is fair and that helps create a reasonable secondary market. An underwriter should be highly market savvy, a good negotiator and

reconciler, and able to artfully price a bond issue under changing market circumstances.

SUMMARY

The underwriter acts as a key intermediary in the process of ushering new issue municipal bond issues from the issuers to investors. The underwriter performs many key activities such as gathering and disseminating vital market information, determining the best bond structures with which to generate interest from investors, and, of course, establishing a market clearing price for the new issue and subsequently allocating bonds to investors. The underwriter must seek to satisfy the needs of two important constituencies: issuers, who seek financing, and investors, who provide it.